Chapter 3

Who is the Customer and Why – The Investor

> *"In the past, [a country's] attractiveness has been closely linked to possession of natural resources or a large domestic market. With the shift toward globalized production and trade, competitiveness as a location for investment and exporting has been become the main determinant of attractiveness." International Finance Corporation, Foreign Direct Investment.*

> *"As competition for private investment intensifies among countries, the [ease] or difficulty in establishing and conducting businesses in any country becomes an important consideration when investors make decisions on location." Jordan Investor Roadmap, 1998.*

Why Focus on the Investor?

As the previous chapter points out, the concept of customer-focused governance is a dynamic one that can be applied to all aspects of government ranging from healthcare to transportation. Why then have the Roadmaps to date focused exclusively on the investor, with a particular focus on the foreign investor? Despite the Roadmap's widespread applicability, there is probably no more potent area of applicability than that of investor approval and business establishment procedures. As will be discussed in this chapter, investment -- and particularly foreign investment -- can bring tremendous economic benefits. Equally important, the foreign investor can choose where -- and where not -- to invest.

A few facts are telling. Global foreign investment flows increased from an annual average of $77 billion in 1983-87 to approximately $430 billion in 1998. Thirty-seven percent of global FDI flows, or $149 billion, went to developing countries in 1997, up from just $34 billion at the beginning of this decade *(see Figure 3.1 – to be completed)*.[1] This was an unprecedented flow of capital around the world, bringing factories, jobs, new technologies, and economic growth to far-flung countries around the globe. This growth was fuelled by the strong shift to market-oriented economies in many parts of the world, a widespread liberalization of both national and global trade and investment regimes, and an accompanying increase in the integration of the world economy.

These investment flows, however, have been unevenly spread around the world. In 1995, 74 percent of FDI flows to developing countries went to only 10 nations.[2] Moreover, entire regions were only minor participants in this global economic expansion. As the United Nations Conference on Trade and Development's (UNCTAD) points out "Africa has been largely bypassed by the recent foreign direct investment boom."[3] By contrast, large countries such as China, and rich developed countries such as the United States were major recipients of this investment. In the developing world, East Asian nations and Latin America also received a large share of these investment flows.

It is the relatively poor performance of African countries in capturing cross-border investment -- and the continent's need for the benefits of that investment -- that led the first Investor Roadmaps to take place in Africa. FDI inflows into Africa increased only modestly in absolute terms, from an annual average of $1.7 billion for 1981-85 to $3.8 billion in 1991-95. Moreover, Africa's share of FDI inflows into developing countries fell from almost 9 percent between 1981-85 to just over 5 percent in 1991-95.[4] This is significant because it indicates that Africa's relative attractiveness as an investment site vis-à-vis other locations has also fallen.

Moreover, this relative decline in FDI flows has also occurred despite the extensive economic reforms adopted by many African nations in recent years. These reforms have led to a substantive improvement in the economic climate in much of Africa, as characterized by positive GDP growth exceeding 4 percent in both 1996 and 1997, reversing a pattern of decades of stagnant or shrinking GDP figures.[5] It is true that aggregate FDI figures mask some of the positive characteristics of current FDI flows into Africa and understate the positive performance of a select few Sub-Saharan countries in attracting investment.[6] Nonetheless, these figures indicate that as a whole, African nations are not reaping the same benefits of the global FDI boom, as are other regions of the world.

What accounts for this lack of response by investors? FDI can be deterred by many factors. Most important, economic and political instability create an inhospitable climate for investment. Similarly, restrictions on FDI, such as limitations on the share of ownership that can be held by foreigners, can deter investors. A large state role in the economy, evidenced by price controls, or a large state enterprise sector, can signal to investors that private firms, responding to market signals, are not wanted. Finally, complex administrative barriers can make it overly difficult for investors to establish and operate business.

Since the late 1980s, however, a significant number of African governments have addressed many of these deterrents. There has been a widespread adoption of structural adjustment and other types of economic reforms, frequently enacted with International Monetary Fund and World Bank support.[7] These reforms have created stable macroeconomic environments characterized by competitive exchange rate regimes, loosened controls on foreign exchange transactions, and tightened fiscal controls; trade liberalizations, including the elimination of import constraints and the rationalization of tariff structures; financial sector reforms to strengthen the banking system; and privatization and other measures to encourage private sector growth.

Many of these structural and fiscal reforms were accompanied by measures aimed at attracting new investment. These included new or revised investment codes; attractive packages of fiscal and other incentives; policies of non-discrimination against foreign investors; export promotion programs such as bonded warehouses and export processing zones; accession to bilateral and multilateral investment treaties; and investment promotion programs aimed at foreign investors, nationals, and expatriate nationals. Multilateral institutions, bilateral donors, and national governments alike expected that this combination of macroeconomic reforms and new investment promotion climates would lead to sharply increased private investment flows.

With the exception of a handful of countries such as Uganda, Ghana, and Tanzania, however, these flows have not materialized. While a number of explanations have been offered for what is now referred to as a "lack of supply response," investment promotion specialists and institutions such as U.S. Agency for International Development (USAID) and the World Bank's Foreign Investment Advisory Service (FIAS) have increasingly focused on the regulations and the bureaucratic requirements facing investors.

While the structural adjustment reforms introduced in many countries addressed many of the deterrents to private investment discussed above, these reforms have predominantly been introduced at the macro level. These "first tier" reforms consisted primarily of changes in policies. While neither the importance, nor the political courage and economic hardship associated with the adoption of many of these changes, should be understated, it is increasingly apparent that these reforms, while necessary, were not sufficient. It is increasingly apparent that additional, "second-tier" reform at the administrative and procedural level is required. While the breadth and depth of first-tier reforms have been instrumental in creating investment climates that are attractive to potential investors, it is widely accepted that reforms at the second-tier level are required to encourage and enable these investors to move forward with the implementation of their investments.

How do Administrative Barriers Deter Investors?

The phrases “bureaucratic constraints” or “administrative constraints” are frequently used, but as with many such shorthand phrases, the real meaning and impact of these constraints is not captured by the term. In particular, these phrases do not reflect the frustrations, lengthy delays, and repetitive steps that must be endured by potential investors in a country where investors are not treated as customers.

These procedural constraints affect businesses at two distinct stages: when trying to receive all the necessary approvals and permits to establish a business and when operating that business after its establishment. At both stages, investors are typically required to have multiple contacts with various government agencies. These may include, but are not limited to, the national investment promotion body; the police; the departments of customs, foreign affairs, justice, health, immigration, internal revenue, lands; and local or municipal authorities.

Each of these agencies may require multiple points of contact, multiple forms, and multiple types of supporting documentation. Each of these may also include multiple requests for bribes to expedite that particular process. In total, these multiple interactions mean that it can take an investor months to receive a single permit, and it may literally take years to receive all the necessary authorizations to establish a business. Overall, the process, and the criteria by which any single application for a permit is approved or rejected, may be completely unclear. This lack of “transparency” is in itself both a deterrent to investors and an opportunity for corrupt behavior.

The following excerpts from the Tanzania Investor Roadmap conducted by The Services Group (TSG) in 1996 illustrate how complex these requirements can be, and demonstrates how these bureaucratic requirements typically affect companies at all stages, from the initial attempt to begin the investment process right through becoming operational.

The process begins when the investor is presented with what is clearly not a customer-friendly environment. The TSG Roadmap consultants experienced first-hand the difficulties faced by investors in setting up a business:

> The absence of up-to-date phone directories and working phones means that appointments are difficult to obtain. As a result, an investor frequently needs to physically visit agencies to get appointments. Offices for many of the agencies are hard to find, particularly for foreign investors; non-functioning lifts sometimes require investors to climb several flights of stairs. Frequently, there is only one official qualified or designated to deal with business start-up issues; this person is often out of the office or on safari. More often than not, the secretary is unaware of the boss' schedule and is unable to set up a more appropriate time for meeting.

> Even when appointments have been pre-arranged, government officials commonly do not appear for meetings. Similarly frustrating is the fact that forms are often not available. The result of all this is that investors commonly need to make three to four trips to get the information and forms that are required from each agency.

The bureaucratic complexity does not end once a firm is operational. After a company has been established, a number of other steps must be undertaken each year. Most of these

> … are related to foreign exchange, labor, and import/export procedures. In all, a firm in [the capital] Dar es Salaam could expect to submit at least 89 separate findings per year. This compares to 21 in Ghana, 29 in Namibia, and 48 in Uganda [at the time of writing]. These figures do not include import or export documentation, repatriation of funds, utility payments, or sectoral forms. The situation can be even worse depending on the sector. A bank in Tanzania is expected to submit 285 returns during the course of a year, while a hotel must submit more than 454 separate documents to various agencies…This long list of operational requirements is evidence that the bureaucratic constraints hampering private sector development do not end once firms are legally established…

These procedural delays and reporting requirements pose strong deterrents to an investor. This is particularly true for investors producing for global markets. The increasing globalization of the world economy and the shortening of product life cycles are compelling manufacturers to operate on a production time frame that is shorter and shorter. A typical cut-make-and-trim apparel manufacturer, for example, will have an order book that stretches only three months into the future. With such a short time horizon, he cannot afford to wait 18 months to receive a construction permit for a new apparel factory; not that is, if he wants to remain competitive in world markets. Moreover, the more time and administrative staff that a company has to devote with complying with filing requirements, the less profitable it will be.

The economic impact of this complex bureaucratic environment on investment is again illustrated by the Tanzanian Roadmap:

> The most obvious [effect] is in reduced investment levels … The decrease in investment inquiries has been even more precipitous….
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> A second illustration of the difficulty of the investment environment can be seen in the relatively small percentage of 100 percent foreign investment projects…A higher level of joint ventures as compared to 100 percent foreign-owned projects is typically indicative of a difficult bureaucracy as foreign investors are unwilling to proceed without a local partner who can better manage the maze of bureaucracy.
>
> The effect of the regulatory and policy environment can be seen in current business operations…Firms that are doing well are largely restricted to trading (and some resource-based) activities; trading activities face fewer start-up barriers and offer much quicker returns.
>
> A final illustration …is the dynamism of the informal sector vis-à-vis the formal sector. It has been estimated by some economists that the Tanzanian GDP is [actually] double official estimates due to the strength of the informal sector. One of the primary reasons

for the growth of the informal sector is because informal entrepreneurs can avoid many of the bureaucratic and regulatory constraints, as well as the high taxes, faced by formal sector firms.

An equally insidious impact of such over-regulation is its impact on encouraging corruption. The more complex a procedure and the more steps that must be completed to receive a permit, the greater the opportunities for corruption. In such a system, each step becomes an individual fiefdom or "toll booth." Thus, bureaucratic complexity, by its very nature, *enables* corruption to occur. The combination of complex procedures and a corrupt environment creates a viscious circle. Again, as noted in the Tanzania Investor Roadmap:

> Businesses need to pay bribes to survive and remain competitive. Not surprisingly, civil servants perceive business people as corrupt, which leads them to erect more controls and more stringent screening processes, resulting in even longer start-up delays. In reaction, businesses resort to bribes to accelerate this process.

This viscious circle thus results in a compounding of the original problem – difficult bureaucratic requirements -- and has a tremendously deleterious effect on governance within the country. Moreover, corruption in and of itself provides a substantial deterrent to foreign investors. [8]

Government-imposed obstacles to investment or business expansion, of course, are not limited to developing countries, of course – as the accompanying cartoon attests. Nonetheless, these obstacles tend to be more pervasive in developing countries, particularly those with a historical tradition of heavy government involvement in the economy. Moreover, the cost of such over regulation in a developed country is largely limited to inefficiency, higher procurement costs, and lowered institutional morale in agencies bound by such rules.

The cost of bureaucratic overregulation in developing countries, however is much higher. As noted in the previous chapter, potential foreign investors – the customer – like any customer, has the power of choice. Foreign investors have a selection of countries to choose from when undertaking a new investment. If the time needed to establish a business is too lengthy, or the process is too complex, the foreign investor may well look elsewhere. As will be seen below, however, the cost associated with losing such potential investment -- in terms of jobs, growth, and technology transfer – can be tremendous.

Foreign Direct Investment: Why does it matter?

If a complex bureaucratic environment deters investors, why does it matter? It matters because there is a widespread -- although not unanimous -- consensus among most economists, academics, donors, and multilateral lending organizations that foreign investment is economically beneficial to the recipient country. Moreover, since the late 1980s, developing country governments have increasingly concurred with this assessment. As discussed above, these countries have accordingly introduced a variety of legal, fiscal, institutional, and administrative reforms in order to attract such investment.[9]

There is a substantial body of economic research on the benefits and costs of FDI to the recipient countries. While not all FDI is necessarily positive in its impact, this research points to a variety of important benefits. FDI creates jobs, which are particularly welcome in developing countries with high unemployment and underemployment. FDI also widens the local tax base and adds to government tax and other revenues. Even if foreign investors are granted complete relief from taxes as an investment incentive, governments typically gain revenue from the payment of personal income taxes on the jobs created by FDI.

While nearly all investment – domestic and foreign -- generates jobs and contributes to GDP growth, foreign direct investment in particular brings a number of ancillary benefits to the host country. Not only is FDI an important source of external capital, but it can also lead to technological spillovers in a developing country. FDI directly promotes these changes by contributing to higher factor productivity, changes in product and export composition, research and development practices, and employment and training.[10] Indirectly, FDI can exert a positive technology impact through technology transfers to local downstream and upstream producers

FDI also frequently brings a number of intangibles to a country. These include new organizational and management skills as well as access to new marketing networks. These intangibles are increasingly important in a globally competitive economy where the ability to package and market a product are as critical as the capability to produce it. FDI can also result in significant skills transfers. Foreign firms usually carry out more on-the-job training than do local firms, and these skills are often transferable to other sectors and activities when employees seek new jobs or establish their own businesses. [11]

FDI can also stimulate competition, innovation, savings and capital formation, and through these, job creation and economic growth. Empirical evidence from south-east Asia and Mexico strongly suggests that foreign firms have spillover effects on the propensity of local firms to export. This is significant because export-led growth has been demonstrated to be a significant contributor to the economic success of a number of countries. In addition, most empirical studies of FDI provide evidence that FDI exerts an efficiency-enhancing effect on locally owned firms, thereby increasing their capability to engage in overseas trade and investment.[12] Finally, there is a positive correlation between FDI and economic growth; in part this results from the benefits discussed above, but it also a self-reinforcing cycle in that growing economies attract investment.[13]

Local Investment Matters Too

While attracting FDI is a key priority for many developing countries, encouraging local investment is also important. Small enterprises, particularly microenterprises, can provide a welfare net to reduce the burden of poverty on those who have no link to the established public or private sector. [14] Moreover, the small- and medium-sized enterprise (SME) sector in many countries has proven to be an important source of economic growth and jobs.[15]

Overly burdensome regulatory and reporting requirements affect local investment in several ways. One, they compel many firms to remain in the informal sector. While these enterprises can still have an important economic impact while operating informally, there are tremendous economic and social costs associated with informality. These costs can include, *inter alia*, a loss of government tax and licensing revenues;[16] an unfair and disproportionate tax burden for firms and individuals in the formal sector; social and other costs resulting from the unenforcibility of informal contracts; and increased corruption as informals pay bribes to avoid being reported.

Informal sector firms are also typically characterized by lower productivity, which results from these firms' constant attempts to evade detection; their undercapitalization and lack of access to formal finance; and their lowered sales resulting from a lack of advertising to prevent detection. Finally, informality usually prevents firms from expanding their operations in the longer-run, due to their lack of access to capital and because it is harder for larger firms to avoid detection from the authorities. As a result, the full economic benefits associated with such enterprise growth are not realized.

Two, a difficult bureaucratic regime has a disproportionately negative impact on small- and medium-sized firms. Moreover, the smaller the firm, the disproportionately larger the impact. This results from the nature of the burden -- as measured by the opportunity cost of the entrepreneur's time -- which is a fixed cost that is more or less the same for all firms. Also, while larger enterprises can afford to hire managers to handle these various interactions with government, smaller firms cannot. From a developmental perspective, the impact on small- and medium-sized enterprises is particularly negative, given the large number of such firms in developing economies and their economic contribution as outlined above. A difficult regulatory climate, therefore is not only particularly burdensome to SMEs, but has a broader impact on a country's development as a whole.

Three, a difficult regulatory environment can be particularly difficult for micro- and small-sized businesses located outside of major urban centers. As noted in the Tanzanian Roadmap,

> it is virtually impossible for small businesses -- particularly those outside [the capital] -- to operate legally. And if the start-up process is difficult for sophisticated large-scale firms, imagine how it appears to unsophisticated, semi-literate, rural entrepreneurs.

This impact on the rural sector is important from a development perspective because the majority of the population, particularly in Africa, lives in rural areas. To the extent that bureaucratic regulation impedes the development and growth of rural non-farm businesses, it will undermine the economic growth needed to reduce levels of poverty in rural areas and lower migration to cities.

Finally, this bureaucratic complexity reduces the profitability and efficiency of firms (and this affects foreign-owned ones as well) once operational. This results from what De Soto termed the "cost of remaining formal;" that is, the cost of complying with a myriad of government requirements. Again, this has both economic, social, and political implications as noted by De Soto:

> …the costs of remaining formal seem to have an excessive impact on the way in which businesses are run, affecting their operations and output independently of the production

> process itself. By altering the allocation of resources, they make production more costly, limit the mobility of the factors of production, and increase the cost of transactions. This alters the profitability of the firm, regardless of its basic economic efficiency. The company's prosperity depends less on how well it does its work than on the costs imposed on it by the law. The owner who handles these costs better or manipulates the firm's relationship with the state is more successful than the one who is concerned only with the job.[17]

In an increasingly competitive global marketplace, such government-imposed costs lower a company's competitiveness, diminish its ability to compete in export markets, and domestically, raises costs to consumers.

The Role of the Roadmap in Enabling Investment

How does the Investor Roadmap address the deterrent impact of complex procedures on investment? The Roadmap introduces a key concepts to the investment approval and business establishment and operation process: the concept of the investor as a *customer*. By creating a focus on the customer, the Roadmap sets in motion a process, which identifies various ways to meet the customer's needs. These can include a simplification of the procedures and requirements needed to set up and run a business; the elimination of certain forms or authorizations; improved transparency in the approval process; and the adoption of a positive customer service attitude, among others. The reason the Roadmap is so exciting to so many is because it offers the potential to reduce administrative barriers to investment, and through investment, to economic growth and development. Moreover, the impact of this approach is not limited to large or foreign-owned companies, but is equally or even proportionately greater for SME firms in both urban and rural areas.

The creation of an investor-friendly, customer-focused environment, and an increased simplification and transparency in government procedures and regulations, can have a substantial impact on investment flows. This impact occurs in three ways. One, the increased simplification reduces the "transaction costs" – that is, the extra time, energy, and expertise required to complete a myriad of forms and to go from office to office -- that deter investment and lower the profitability of investment. As a result, potential investors are more likely to make a decision to invest and to proceed with that decision. In addition, existing firms can spend more time on their business, as opposed to complying with government regulations.

Two, the combination of increased transparency and simplified procedures (that is, fewer "tollbooths") reduces the opportunities for corruption. Corruption (or "rent-seeking behavior" in economic parlance), also increases transaction costs, as well as actively deters many potential investors. And finally, there is substantial cost to government from maintaining a complex and multi-layered bureaucracy, from screening complex investment application forms to judge the viability of an investment, from printing multiple forms, and the like. The introduction of simplified procedures enables these resources to be redirected elsewhere in the investment bureaucracy. Increased transparency and simplification, therefore, is to the benefit of both the investor and the government.

In this sense, the Roadmap *enables* or facilitates investment. The Investor Roadmap does not directly create investment. Nor can it overcome other deficiencies in the national investment climate that may deter investors -- deficiencies such as macroeconomic imbalances as indicated by high inflation or unrealistic exchange rates; inadequate or unfocused investment promotion efforts; political instability; weaknesses in national or local infrastructure; etc. Nonetheless, the Roadmap offers governments the potential to create a procedural system that is receptive to investors; easily accessed by both foreign and local, and large and small, companies; and that can be implemented without major and politically disruptive policy or legal changes or reforms. How the Investor Roadmap can lead to the development of such a system, and what perils and pitfalls the process may experience along the way, is explored in the following chapters.

End Notes

[1] International Finance Corporation, Foreign Investment Advisory Service, Foreign Direct Investment, Washington DC, 1997, p. 6; and "New Records Being Set in Global Foreign Direct Investment, Despite Financial Crises," UNCTAD Press Release TAD/INF/2775, 2 November 1998, p. 3.
[2] IFC, Foreign Direct Investment, p. 6.
[3] UNCTAD, "Foreign Direct Investment in Africa: Performance and Potential," UNCTAD/ITE/Misc.5, 8 September, 1998, p. 5.
[4] FDI inflows into Africa more than doubled from an annual average of $1.7 billion from 1981-85, to $2.8 billion in 1986-1990, to $3.8 billion in 1991-95. During the same period, however, inflows to developing countries as a group more than tripled from less than $20 billion in 1980-85 to an average of more than $70 billion in the years 1991-95. Ibid., p. 5.
[5] This positive growth in GDP has also been aided by external factors such as increasing commodity prices. UNCTAD, "Foreign Direct Investment in Africa," pp. 3, 5.
[6] For example, UNCTAD reports that FDI in Africa is characterized by several positive trends. These include a growing diversification in FDI flows away from traditional sources of investment (France, Germany, the United Kingdom, and the United States) to include smaller OECD countries and investors from developing country regions such south-east Asia; the growth in inter-African FDI; the relatively higher profitability of FDI in Africa and the growing sectoral diversification of investment from the primary sector to the manufacturing and services sectors. Moreover, some individual countries such as Uganda and Tanzania have substantially outperformed the rest of the continent in recent years and have registered large inflows of FDI. UNCTAD, "Foreign Direct Investment in Africa," pp. 8-13.
[7] As of December 1997, 22 African countries had extended Structural Adjustment Facilities Agreements (ESAF) agreements with the IMF. ******, African Economic Report - 1988, p. 12.
[8] According to a survey of commercial banks, investment banks, and mutual fund managers. Bhattacharya, Ama, et al. "How Can Sub-Saharan Africa Attract More Private Capital Inflows?," Finance and Development, June 1997, p. 6. This finding is confirmed by a survey of nearly 4,000 businesses in 69 countries, which found that corruption was perceived as the number one obstacle in 6 of the 22 regions considered, and among the top 3 obstacles in all the African regions and all but one of the former Communist regions. Brunetti, Aymo, Gregory Kisunko, and Beatrice Weder, "How Businesses See Government: Responses from Private Sector Surveys in 69 Countries," IFC Discussion Paper No. 33 (World Bank, Washington, DC, 1998), p. 17.
[9] Some 50 countries in the 1990s have enacted new investment laws. The number of bilateral treaties on the promotion and protection of investment increased almost threefold in the 1990s, to about 1,100. World Bank, Global Development Finance, 1997, Vol. 1. Washington, DC, p. 33.
[10] Global Development Finance, 1997, p. 31.
[11] Danziger, Errol. Danziger's Investment Promotion Manual: Handbook for Organizations Promoting Foreign Direct Investment. London: FDI International Ltd., 1997, p. 9.
[12] World Trade Organization (WTO) Secretariat), "Trade and Foreign Direct Investment," October 6, 1996, pp. 13, 17.
[13] World Bank, Global Development Finance, 1997, Vol. 1. Washington, DC, p. 31.
[14] Levy, Brian. Obstacles to Developing Small and Medium-Sized Enterprises: An Empirical Assessment," PRE Working Papers, WPS 588, World Bank: Washington, DC, February 1991, pp. 2,47.

[15] This is particularly true in East Asia. In Taiwan, SMEs account for at least 90 percent of the enterprises in each sector, and produce 60 percent of the total value of exports (1992 data). In Japan, SMEs accounted for 52 percent of manufacturing value added and sales (1989 data). While Korea's development was driven by large conglomerates (chaebols), the SME sector began to grow rapidly in the 1980s and accounted for 5.2 percent of total manufacturing employment by 1988 and 34.9 percent of manufacturing value-added. World Bank, The East Asian Miracle: Economic Growth and Public Policy, Washington, DC: 1993, pp. 161-63.

[16] These other revenues can be considerable, depending on the sector. As identified by the Tanzania Investor Roadmap, between 50 and 70 percent of Tanzania's minerals were exported illegally due to the high tax regime and the difficulty in obtaining licenses. In addition, government revenues were harmed because various regulatory constraints hampered the development of the mining sector. "Mining Sector Faces Tough Tax Laws, " Daily News (Tanzania), January 10, 1997.

[17] De Soto, The Other Path, p. 151l